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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 270

HELEN BLESI PEARSON AND J. CHARLES PEARSON, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 119-131) is reported at 13 T. C. 851. The opinion of the Court of Appeals (R. 185-190) is reported at 188 F. 2d 72.

JURISDICTION

The judgment of the Court of Appeals was entered on April 11, 1951. (R. 190.) The petition for rehearing was denied May 24, 1951. (R. 208.) The petition for a writ of certiorari was filed

August 22, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether taxpayer, the heir of a lessor of land, is entitled to depreciation deductions under Section 23(l) of the Internal Revenue Code with respect to a building erected at the lessee's expense and having a useful life shorter than the term of the lease.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra,* pp. 12-15.

STATEMENT

The facts as stipulated (R. 22-27) and found by the Tax Court (R. 121-125) may be summarized as follows:

The taxpayers are husband and wife who, on a community basis, reported the income from and claimed a disputed deduction for depreciation with respect to certain property in their separate income tax returns. (R. 121.) For convenience the wife will be referred to as the taxpayer.

On March 1, 1919, the taxpayer's grandparents, Charles T. Rowan and Ellen Rowan, executed a lease on a certain lot which they owned in community, located in downtown Dallas, Texas. The lease was for a term of 66 years and 10 months, ending December 31, 1985. (R. 121-122.)

The lease provided for the payment of a rental of $15,000 a year until December 31, 1925, and of $16,500 per year thereafter until December 31,

1985. The lease also provided that the lessee should erect on the property a building of specified, minimum requirements, which was to cost not less than $100,000. It also provided that all improvements erected on the premises should become and remain the property of the lessors, and that upon its termination or forfeiture possession of the premises should be delivered to the lessors or their representatives, wear and tear excepted, in a good tenantable condition. (R. 122-123.) In 1928, the lessee constructed a ten-story building on the property at an approximate cost of $500,000. In 1935, an additional six floors and penthouse were completed at a cost of $485,205.91. The building, known as the Gulf States Building, has an estimated useful life of 50 years from the time of its completion in 1928. (R. 123.)

On July 14, 1919, Charles T. Rowan conveyed his interest in the property to his wife, Ellen Rowan. He died in 1924. Shortly thereafter Ellen Rowan executed a deed conveying her interest in equal shares to her three children, one of whom was the taxpayer's mother. This deed was not recorded until shortly after the death on June 20, 1940, of Ellen Rowan. (R. 122.) The federal estate tax return filed for the estate of Ellen Rowan did not include in the gross estate any value with respect to this property. The Commissioner, however, on the ground that the deed had not been delivered to the children, and for other reasons, adjusted the estate tax return to include a value of $412,500 for

the interest of Ellen Rowan in this property, giving the following explanation (R. 124):

> This property was under a 66-year lease at $16,500.00 per year net rental payable monthly is centrally located and improved with an excellent office building of about fourteen stories and any improvements on the lot will revert to the lessors at the expiration of the lease in 1985. Recommended value based upon allowance to the Estate of four per cent return on their investment.

This deficiency was agreed to and additional estate tax was paid accordingly. (R. 124.)

The taxpayer's mother was one of the three children to whom Ellen Rowan transmitted her interest in the property. The taxpayer inherited all of her mother's undivided interest in the property on her mother's death in 1941. The taxpayer has since held the property for business use and production of income. (R. 122.)

In the estate tax return of the taxpayer's mother, a value of $137,500 was included (as property previously taxed), that sum being her one-third interest in the property and being one-third of the valuation used by the Commissioner in adjusting the estate tax return of Ellen Rowan's estate. The Commissioner made no adjustment in respect to this inclusion. (R. 124-125.)

In 1940 and 1941, the City of Dallas assessed values for the property as follows: for the land $348,753 in both years; for the building, $488,647

in 1940, and $493,507 in 1941. (R. 125.) It was stipulated (R. 26) and the Tax Court found (R. 125) that "the fair market value of the Gulf States Building in both 1940 and 1941 was at least $450,000." The Tax Court found that a reasonable return on an investment in similar property located in downtown Dallas, Texas, was eight percent. (R. 125.)

During 1942, 1943, 1944 and 1945, the lessee claimed depreciation deductions with respect to the cost of the Gulf States Building based on a 50-year life, and such depreciation deductions were allowed by the Commissioner. (R. 125.)

During the taxable years the taxpayer (together with her husband) claimed a total yearly deduction for depreciation of $3,197.70 which was disallowed by the Commissioner. (R. 9-20, 156-167.) The Tax Court, five judges dissenting, refused to uphold the Commissioner's deficiency determinations, holding that the taxpayer was entitled to deductions for depreciation. (R. 120-131.) The Court of Appeals reversed (R. 185-190), and taxpayer's petition for rehearing was denied (R. 208).

ARGUMENT

1. The right to "depreciation" deductions in computing taxable income is granted by Section 23(l) of the Internal Revenue Code (Appendix, *infra,* p. 12), which authorizes deduction of a reasonable allowance "for the exhaustion, wear and tear" of property used in the taxpayer's business or held for the production of income. The purpose

of the allowance, as explained in the applicable Treasury Regulations (Section 29.23(l)-1 of Treasury Regulations 111, Appendix, *infra,* p. 14), is to permit the taxpayer to set aside each year an amount which will "at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113." See also Section 29.23(l)-2 of Treasury Regulations 111 (Appendix, *infra,* pp. 14-15). The "basis" for computing the amount of depreciation deductible annually is the "cost" of the property or, in the case of a taxpayer who acquired it by inheritance, the "fair market value" at the time of its acquisition. Sections 113(a)(5) and 114(a) of the Internal Revenue Code (Appendix, *infra,* pp. 12-13). The "basis" provisions of the statute are not reached, however, unless the taxpayer claiming the deduction possesses a depreciable interest in the property in respect of which the depreciation is claimed. *First Nat. Bank of Kansas City* v. *Nee,* 190 F. 2d 61 (C.A. 8th).

The court below correctly held that taxpayer, the heir of a lessor of land (a non-depreciable asset), possessed no depreciable interest in a building (a depreciable asset) which was erected at the lessee's sole expense and had a useful life shorter than the term of the lease. It is well established that only one who suffers economic loss from the depreciation of property owns a depreciable interest in it for tax purposes, irrespective of who has

the legal title. *Helvering* v. *Lazarus & Co.,* 308 U. S. 252; *Duffy* v. *Central R. R.,* 268 U. S. 55; *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364; *Weiss* v. *Wiener,* 279 U. S. 333. In this case the decedent-lessor admittedly had no depreciable interest in the building while she lived. She had a fee interest in land subject to an outstanding lease, with the right to receive the ground rent, an interest not subject to depreciation. *First Nat. Bank of Kansas City* v. *Nee, supra; Friend* v. *Commissioner,* 119 F. 2d 959 (C.A. 7th), certiorari denied, 314 U. S. 673; *Reisinger* v. *Commissioner,* 144 F. 2d 475 (C. A. 2d). The entire depreciable interest in the building resided in the lessee. Section 29.23 (a)-10 of Treasury Regulations 111 (Appendix, *infra,* pp. 13-14). Since the decedent-lessor had no depreciable interest in the building during her lifetime, she could transmit none to taxpayer upon her death. After the lessor's death, as before, the depreciable interest in the building remained in the lessee, who continued to suffer the economic loss resulting from its deterioration. The depreciable interest, and the concomitant right to depreciation deductions, did not shift from the lessee to the lessor's heir (taxpayer) by virtue of the lessor's death. *First Nat. Bank of Kansas City* v. *Nee, supra; Friend* v. *Commissioner, supra.*

The majority of the Tax Court mistakenly assumed (R. 128) that taxpayer acquired a depreciable interest in the building merely because (1)

the parties stipulated the fair market value of the building as of the date of the lessor's death, and (2) this stipulated value happened to be less than the amount attributed to the decedent-lessor's interest in the realty for estate tax valuation purposes. As the court below pointed out (R. 188-190), the undisputed facts conclusively show that the estate tax valuation of the lessor's interest was attributable in its entirety to the land alone (as distinguished from the building), the valuation having been reached by capitalizing at 4% the ground rental for the remainder of the lease (R. 124). In the words of the court below (R. 189), the stipulation of the parties as to the fair market value of the building was never intended "to value the taxpayer's, as opposed to the lessee's, depreciable interest therein," and "cannot on this record be taken as proof that the building was accorded any value as a depreciable asset in the hand of the taxpayer." The petition for certiorari proffers no answer to the reasoning of the court below. It proceeds solely upon the hypothesis, without basis in the record, that the stipulation of the parties as to the fair market value of the building *ipso facto* established that taxpayer possessed a depreciable interest in the building.

2. The decision below is not in conflict with any decision of this Court or of any of the Courts of Appeals. The only other case presenting the question here involved which has reached an appellate court is *First Nat. Bank of Kansas City* v. *Nee*,

190 F. 2d 61 (C. A. 8th), and the decision in that case is in complete accord with the decision below.

Neither *Crane* v. *Commissioner,* 331 U. S. 1, nor *Brown Shoe Co.* v. *Commissioner,* 339 U. S. 583, upon which taxpayer relies for conflict (Pet. 13-15), presented an issue comparable to that here involved. In the *Crane* case this Court sustained the Commissioner's position that mortgaged property (in which the taxpayer concededly had a depreciable interest) must be valued at its actual physical value, undiminished by the amount of the mortgage, rather than by the value of the "equity" in the property, in determining its basis for depreciation and for gain or loss on its sale. In the *Brown Shoe Co.* case it was held that property contributed to a corporation by community groups, or acquired by it with cash contributed by such groups, represented "contributions to capital" of the corporation within the meaning of Section 113(a)(8) of the Internal Revenue Code, and hence was includible in the corporation's basis for depreciation. The two Court of Appeals cases, *Blanchard* v. *Commissioner,* 184 F. 2d 438 (C. A. 3d), and *Rogers* v. *Helvering,* 107 F. 2d 394 (C. A. 2d), with which taxpayer also asserts conflict (Pet. 17-18), involved nothing more than evaluations of stock. None of these cases upon which taxpayer relies deals with the problem here, namely, whether a lessor of land, or his successor, acquires a depreciable interest in improvements erected by the

lessee and having a useful life shorter than the term of the lease .

3. To permit a lessor of land (or his heirs) to deduct depreciation on account of a building whose entire cost was incurred by the lessee, and whose useful life will end before the land reverts to the lessor, would produce the incongruous result that duplicate depreciation deductions could be taken by the lessor and the lessee with respect to the very same property. But in such a case the entire burden of the economic loss, which the statutory allowance for annual depreciation is designed to offset, falls upon the lessee, and it is he alone who is entitled to the deduction. The Treasury Regulations expressly provide that a lessee who erects improvements which have a useful life less than the term of the lease may take annual deductions in "the form of an allowance for depreciation," so as to spread the cost over the useful life of the improvements. Section 29.23(a)-10 of Treasury Regulations 111 (Appendix, *infra*, pp. 13-14). In fact, during the taxable years, depreciation deductions with respect to the building here involved were claimed by and were allowed to the lessee. (R. 125.) The lessee's right to deduct the depreciation of the building over its useful life precludes any notion that the lessor (or his heirs) is entitled to the same deduction.

CONCLUSION

The decision below is correct. There is no conflict, and no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1951.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) [As amended by Sec. 121(c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(5) *Property Transmitted at Death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be

the fair market value of such property at the time of such acquisition. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

(26 U.S.C. 1946 ed., Sec. 114.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(a)-10. *Rentals.* * * * The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than

the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation. * * * If, in any case, the life of the improvements is less than the number of years the lease has to run, including the renewal period if properly to be considered, the deduction for depreciation with respect to such improvements shall be spread only over such life.

SEC. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. * * *

SEC. 29.23(l)-2. *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23

(a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. * * *

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